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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1961.

No. 87.

MANAGED FUNDS, INCORPORATED,
Petitioner,

vs.

J. JOHN BROUK et al.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

BRIEF

For Respondents, J. John Brouk, Jefferson J. Rebstock, Earl R. Rice, W. Munro Roberts, Jr., and James J. Mullen, Jr.

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INTRODUCTION.

Respondents, J. John Brouk, Jefferson J. Rebstock, Earl R. Rice, W. Munro Roberts, Jr., and James J. Mullen, Jr., constitute all of respondents except Jacob Baker and George H. Shields, III, and wherever the word "respondents" is used in this brief it will embrace the five aforenamed. Petitioner will be referred to as "Fund."

OPINIONS BELOW.

The District Court overruled motions of respondents to dismiss Fund's amended complaint for lack of jurisdiction of the subject matter and also lack of jurisdiction of the person respecting respondents, Earl R. Rice and Jefferson J. Rebstock. The District Court filed no opinion. The opinion of the Court of Appeals reversing the order of the District Court is reported at 286 F. 2d 901, and printed beginning at page 40 of the Record.

JURISDICTION.

The jurisdiction of this Court rests on 28 U. S. C. 1254 (1).

QUESTIONS PRESENTED.

Section 44 of the Investment Company Act of 1940 entitled "Jurisdiction of Offenses and Suits" creates concurrent jurisdiction in District Courts of the United States and State Courts of "all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of" the Act.

The question presented is whether the amended complaint charges facts which under the Act constitute violations of federally created statutory duties respecting directors of registered investment companies so as to give rise to a cause of action by Fund against its directors within the jurisdiction of the District Courts of the United States.

STATUTE INVOLVED.

The statute involved is the Investment Company Act of 1940. The portions relied on by petitioner are set out in the Appendix to petitioner's petition at page 61.

STATEMENT.

The type of case involved on the petition for certiorari here before this Court is a civil action for an accounting and in tort for damages brought by petitioner, Managed Funds, Incorporated, a mutual fund and registered investment company, against its investment adviser, the companies which sold its shares, its officers and directors, its New York broker and some of the broker's employees.

There is presented here only the question of federal jurisdiction respecting seven directors.

By the judgment of the United States Court of Appeals for the Eighth Circuit in Brouk et al. v. Managed Funds, Incorporated, et al. (286 F. 2d 901, R. 72), the District Court was ordered to dismiss the case as to seven former directors of Fund who attacked the Fund's amended complaint (and the Josephson complaint) by motions to dismiss for lack of federal jurisdiction of the subject matter and with respect to respondents, Jefferson J. Rebstock and Earl R. Rice, also, lack of jurisdiction of the person (R. 21-28).

On May 12, 1959, Emanuel Josephson brought a stockholder's derivative action for the benefit of Managed Funds, Incorporated, in the District Court of Delaware. This action was subsequently transferred to the District Court at St. Louis (R. 12). This complaint was adopted by intervenor, Protective Casualty Insurance Company (R. 39). On October 23, 1959 Fund filed its amended complaint in the District Court (R. 1). Only Fund appeared on the appeal heard by the Court of Appeals (286 F. 2d 901). Fund is the only petitioner here.

The judgment of the Eighth Circuit is, therefore, final respecting the complaint of Emanuel Josephson and the adoption thereof by intervenor, Protective Casualty Insurance Company. It follows that here before the Court for consideration is the amended complaint of Fund.

The identity of the parties defendant in relationship to Fund is as follows:

These respondents are five of a group of twelve former directors who are collectively described in petitioner's amended complaint as "outside directors" (R. 3).

Defendants, Hilton Slayton and Hovey Slayton, are former officers and directors of Fund. Defendant, Slayton Associates, Inc., was the investment adviser of Fund under a contract of August 15, 1952 approved by Fund's shareholders and successively renewed by the directors until April 19, 1959. Defendants, Slayton & Company, Inc., and Mutual Fund Distributors, Inc., were underwriters engaged in selling Managed Fund shares to the public. Defendant, Model, Roland & Stone, is a partnership of eleven individuals and are New York brokers (R. 3). Defendants, James S. Stubbs and Harold W. Smith, are employees of the broker partnership. Defendant, Stephen M. Jaquith, was an associate of the defendant broker partnership. None of these defendants challenged the jurisdiction of the District Court. The case is still pending in the District Court respecting the asserted liability of such defendants.

The averments respecting the outside directors are as follows:

> "On information and belief, the said outside directors, and each of them, had either actual knowledge of the acts hereinafter complained of, or, in the performance of the duties and obligations imposed upon them by law as directors, and by the exercise of ordinary care and diligence in the performance of such duties and obligations, would have acquired knowledge of such acts, and hence are chargeable with having constructive knowledge thereof" (R. 3).
>
> "Plaintiff further states, on information and belief, that the defendants committed, or with actual or con-

structive knowledge, as hereinabove set forth, aided, abetted, acquiesced in or condoned, directly or indirectly, violations of the Investment Company Act of 1940, in that, inter alia,

(a) The plaintiff was operated, managed and its portfolio securities were selected, in the interest of directors, investment advisers, and other affiliated persons thereof, and in the interest of underwriters, brokers and dealers, rather than in the interest of all classes of plaintiff's security holders (R. 6);

(b) The plaintiff was caused to publish, circulate and file with the Securities and Exchange Commission required registration statements, amendments thereto, reports and prospectuses, which documents contained untrue statements of material facts or omitted to state material facts required to be stated therein or necessary to make the statements therein not misleading (R. 7);

(c) The plaintiff was caused to deviate from a fundamental policy recited in its registration statement pursuant to Section 8 (b) (2) of the Act, without being authorized to do so by the vote of a majority of its outstanding voting securities; and

(d) Defendants Leo Model, Rolf R. Roland, Frits Markus, Robert Rosenberg, Walter H. Berton, Walter S. Morris, Frank L. Thompson and Herman H. Stone, as members of a co-partnership doing business under the name of Model, Roland & Stone, and Stephen M. Jaquith, individually, served or acted as investment advisers of the plaintiff, without a written contract approved by the vote of a majority of the outstanding voting securities of plaintiff" (R. 7).

The pleading further states:

"All of said defendants' acts were unlawful and wrongfully committed as a part of, and pursuant to, an

unlawful agreement and conspiracy between all of said defendants, except said outside directors for the purpose of unlawfully making use of the business and funds of plaintiff, to the plaintiff's damage and to the great profit of the said defendants; and said outside directors, as hereinabove set forth, had either actual or constructive knowledge of, did nothing to prevent the consummation of, and are hence chargeable with liability for, such unlawful agreement and conspiracy" (R. 11, 12).

The facts pleaded are that the adviser, Slayton Associates, Inc., was employed by Fund as investment adviser August 15, 1952, and thereafter on December 1, 1953, contracted with defendant Jaquith to act as investment counselor and manager of the securities portfolio of Fund, after which time Associates, as adviser, received fees for advisory services not performed by reason of it having unlawfully delegated its duties to Jaquith and abdicated its duties and responsibilities under its advisory contract with Fund (R. 4, 5). The 1953 contract provided Jaquith was to receive $50,000.00 per annum for five years and $35,000.00 for the succeeding five years as minimum payments to apply against brokerage commissions respecting business which the adviser, Slayton Associates, would direct to Jaquith or his designees. The broker defendants, Model, Roland & Stone, it is averred, became the designee and brokerage business was directed to them whereby they received brokerage commissions in excess of $1,500,000.00 (R. 5). The brokers are averred to have paid to defendants, Smith & Stubbs, annual brokerage commissions in excess of $50,000.00 a year. It is then averred that after Jaquith and Model, Roland & Stone furnished advisory service the Fund's basic policy of capital growth was not followed and gross mismanagement resulted. Loss and damage to the investment portfolio of Fund ensued, as well as greatly increased brokerage commissions and

greater payments under the sales contracts without any benefit to the Fund (R. 6).

Respecting Counts II, III and IV of the amended complaint Fund states (Brief p. 6):

> "The Managed Fund's complaint contains three other counts: Count II (R. 8) asserts liability for losses under the Securities Act of 1933; Count III (R. 9) bases liability for breaches of fiduciary duties; and Count IV (R. 11) seeks recovery on the claim of a conspiracy. Count III reasserts jurisdiction under the Investment Company Act, but adds that 'the unlawful and wrongful acts' constituted breaches of fiduciary duty at common law. Standing alone even without reference to the statute such counts may be joined with petitioner's statutory claim."

Thus, it is conceded these are common law counts cognizable in a Federal Court only if pendente to a federal case if one is stated by Count I.

The amended complaint presents no question respecting the regulatory provisions of the Investment Company Act and the administration of the law by the Securities and Exchange Commission. There is no averment pointing to any specific provision of the Act whereby a federally created private civil action for damages is authorized or created in favor of an investment company against its directors. The relief sought is that the actual wrongdoing defendants account and make restitution to Fund, and that Fund also recover in tort claimed damages against the outside directors who received nothing. The question is whether the amended complaint states facts regarding acts of the respondents as independent directors which are violations of duties of a federal nature having their origin in the Act so that federal jurisdiction may be implied to sustain a private action for damages.

OUTLINE OF ARGUMENT.

The decision of the court in Brouk v. Managed Funds et al., 286 F. 2d 901, that the enactments of the Investment Company Act of 1940 "do not justify implications that jurisdiction was intended to be conferred" and that the omission of provisions for private civil remedies was deliberate is amply supported by the legislative history of the Act and in accord with sound principles governing the doctrine of implied liability for asserted violations of criminal statutes.

The Investment Company Act of 1940 does not expressly or by implication impose new federal statutory standards of responsibility or new federal statutory duties respecting directors of mutual funds, the violation of which affords a basis for the application of the doctrine of implied liability and implied federal jurisdiction of private civil actions.

A. The Wagner-Lea Bill, as originally introduced, provided that directors would be required to register with the Securities and Exchange Commission, and gross misconduct and gross abuse of trust was to be made a crime so as to place upon individuals a sanction for misfeasance. These provisions were deleted and the Bill changed to make theft and conversion a crime and to authorize the Commission to enjoin directors from serving as such if guilty of gross abuse of trust. The original provisions were objected to as providing too indefinite a standard of conduct. The changes made in the Bill indicate a Congressional intent not to enter the field of director duties and liability. Hence a private civil action cannot be maintained in the federal courts.

B. The doctrine of implied liability is not applicable in situations where the application thereof requires the

courts to erect standards of responsibility for tort liability when Congress had refrained from prescribing such standards and abstained from creating private civil actions. A judicially created standard that directors should act in a "meaningful fashion"* prescribes a standard more vague than that abandoned by Congress when it enacted the legislation.

C. Federal jurisdiction must be pleaded affirmatively and distinctly.*

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* Brown v. Bullock, 194 F. Supp. 207, affirmed Second Circuit C. C. H. Fed. Sec. Law Rep. Current Par. 91045, pages 93515-93523.

ARGUMENT.

I.

A. The legislative history of the Investment Company Act.

In searching the petitioner's brief to glean from it the precise basis upon which the Fund seeks recovery from the independent director respondents, one has difficulty in discerning with precision what petitioner's contention is. It disavows any claim that an "insurer's liability" is asserted and states that it has contended all along "that it is not insurer's liability (liability without fault) which Fund seeks to impose upon respondents" (Brief 54). It says that the outside directors committed affirmative acts which were "positive breaches of their statutory duty" by renewing the advisory contract (Brief 58). Respecting the payments made to brokers, Fund says this "is not mere negligence, but gross misconduct based upon respondents' own positive acts, and when the Fund under that management performed the contract they violated the prohibitions of the statute" (Brief 58). Speaking of the violation of the stated policy, Fund says that the policy of the directors "resulted in gross 'mismanagement' to the benefit of the insiders" (Brief 58). Fund argues that even when the directors did not "directly profit by the unlawful operation, they must be held to have accepted the responsibility, powers and duties specifically imposed by the statute", and that they must "be held to respond in damages if they breach the very duties the law imposes upon them" (Brief 59). Finally, Fund summarizes in its conclusion its contention that it is entitled to recover damages from the respondents for "breach of statutory duty and violations of the Act", and that "that is why Congress made illegal the **corporate acts**

approved by these directors and created a new substantive law requiring specific corporate procedures in entering into and supervising, self dealing advisory contracts,— and imposing the penalties and sanctions of illegality and voidness, in case of any departure from these statutory procedures" (Brief p. 59).

Citing criminal cases, Fund argues a corporation can only act by its officers and directors, and that consequently when corporate acts are proscribed the sanction falls upon the individuals rather than the corporate entity whose act is made unlawful. The brief for the Securities and Exchange Commission, amicus curiae, takes a similar approach, but does not predicate the contention on criminal case authority. The argument of the Solicitor General is that although:

> "the particular statutory provisions which the respondents are alleged to have violated do not, in terms, specifically apply to directors, all the statutory prohibitions and obligations that the Act imposed upon registered investment companies necessarily also applied to the directors who governed the company. The complaint in this case, therefore, charges that the directors have breached their statutory fiduciary obligations toward the Fund by participating in the illegal acts alleged" (S. E. C. Brief 13).

Fund contends the Court in Brouk injected a false concept in mentioning "per se" liability and attributing to Fund the contention that it was asserting liability by virtue of the office of director rather than their acts. It says vicarious liability is not claimed.

There is an obvious fallacy in the foregoing contentions. The premise is that a mutual fund in corporate form can only act or be caused to act by its directors, and that a private action therefor exists in favor of share-

holders individually or "collectively, i. e., the investment company itself" (S. E. C. Brief 10) against the directors. Under this hypothesis the Fund is liable to no one, the directors to everyone. Every unlawful act becomes that of the directors, but the Act, by its terms, regulates investment companies, not directors, and such was the intent and purpose of the legislation.

As shown by the "Hearings Before a Subcommittee on Interstate and Foreign Commerce of the House of Representatives, Seventy-Sixth Congress, Third Session, on H. 10,065," the Investment Company Act of 1940 was introduced in the House March 14, 1940 by Congressman Lea as H. R. 8935, and in the Senate by Senator Wagner as S. 3580. Hearings were held before a "Subcommittee of the Committee on Banking and Currency of the United States Senate, Seventy-Sixth Congress, Third Session on S. 3580." S. 4108 was then reported out by the Senate Committee on Banking and Currency. The same Bill became H. 10,065. S. 4108 represented the results of the Senate Hearings, and involved material changes in S. 3580. The original Wagner-Lea Bill appears in Part 1 of the published reports containing "Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-Sixth Congress, Third Session on S. 3580." Part 2 continues the published reports of the hearings. The House report respecting H. 10,065 is found in House Miscellaneous Reports, Volume 4 of the House Reports of the Seventy-Sixth Congress, Third Session, being Report No. 2639. The Senate Report appears in Senate Miscellaneous Reports, Volume 3, Seventy-Sixth Congress, Third Session, being Report No. 1775. Section 9 of the Bill as originally introduced provided in part as follows:

> "Sec. 9 (a) It shall be unlawful for any person, **unless registered under this section**, to serve or act in

any of the following capacities for a period exceeding sixty days:

(1) as officer, **director**, manager, or investment adviser of or for a registered management investment company or registered face-amount certificate company;

(2) as depositor, manager, or investment adviser of or for a registered unit investment trust;

(3) as principal underwriter for a registered open-end management investment company, registered unit investment trust, or registered face-amount certificate company; or

(4) as a distributor who makes use of the mails or any means or instrumentality of interstate commerce to engage in the business of selling periodic payment plan certificates, or as a salesman for such a distributor.

. . . . . .

(e) Any of the persons enumerated in subsection (a), and any person who presently contemplates becoming such an officer, director, manager, investment adviser, depositor, principal underwriter, distributor, or salesman may be registered under this section by filing with the Commission an application for registration. Such application shall contain such information and documents, in such form and such detail, as to such person and affiliated persons of such person as the Commission may by rules and regulations prescribe as necessary or appropriate to effectuate the purposes of this title". . . . (Page 75).*

Relevant to Section 9 was Section 17 (e) of the original Bill, which provided:

* Page references are to Part 1, Hearings S. 3580, Subcommittee of the Committee on Banking and Congress, United States Senate, Seventy-Sixth Congress, Third Session.

"(c) Any gross misconduct or gross abuse of trust in respect of a registered investment company, on the part of **any person registered under Section 9** as an affiliated person of, or principal underwriter for such company, shall be unlawful." (Part 1 Report, Page 12.)

With reference to Section 9, David Schenker, Chief Counsel, Securities and Exchange Commission, advised the Senate Committee:

"Whom do we desire to register with respect to this —an officer, director, manager, or investment adviser? Those are the people who run the company. . . . Now, the proposed recommendation of the Commission is that, in connection with any misfeasance by the officer or directors, **the sanction shall be placed upon the individuals who are guilty of the misfeasance.** Therefore, we think it is essential, and that is why we propose in our recommendation that there be registration of those who are intimately tied up with the management of the company and intimately tied up with the distribution of their securities." (Page 200.)*

At page 202,* the following discussion occurred between Senator Taft and Mr. Schenker:

"Senator Taft (interposing): I do not know of any industry where directors and officers have to register. Isn't this something new in legislation?

Mr. Schenker: Well, Senator, you take under the Securities Exchange Act of 1934, Section 15; every over-the-counter broker and dealer had to register, and it seemed to us, Senator, if Congress——

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* Page references are to Part 1, Hearings S. 3580, Subcommittee of the Committee on Banking and Congress, United States Senate, Seventy-Sixth Congress, Third Session

Senator Taft (interposing): It says any officer, director, manager, or investment adviser. The banks are more important than these, and you do not require people to register to become managers of banks or presidents or vice presidents. If you are going to do it at all, should you not begin with banks?

Mr. Schenker: On that aspect, Senator, no banks, in my opinion, would put on the board of directors any individual who did not satisfy——

Senator Taft (interposing): That is not answering my question at all. I am asking you whether there is any other industry in the world that requires registration for officers, directors, managers, and advisers of companies. Do you know of any such industry?

Mr. Schenker: Do I know of any other industry? No; Senator."

Following the foregoing a discussion occurred between Mr. Schenker, Senator Taft and Senator Wagner, joined in by Honorable Robert E. Healy, Commissioner, Securities and Exchange Commission, with respect to the form of application for registration of directors, at the conclusion of which Senator Taft said, pages 204, 205:*

"Senator Taft: My suggestion is that the approach to the regulation of investment trusts should be the same as the approach to the regulation of banks, which incidentally, have far more money to handle for stockholders and depositors than investment trusts. I suggest that periodical published statements and examinations of the investment trusts' books by a corps of bank examiners whenever they chose to walk in would be simpler than the plan proposed here. This would be sounder, I think, than the plan pro-

* Page references are to Part 1, Hearings S. 3580, Subcommittee of the Committee on Banking and Congress, United States Senate, Seventy-Sixth Congress, Third Session.

posed here, handing over to the S. E. C. the regulation of the companies **and their directors and officers**. I do not question the need of regulation, not that these revelations show the most outrageous treatment of other people's money, nor that it has been revealed by the excellent work of the S. E. C.; I do not mean to question any of that at all."

Respecting Section 17 (e), Mr. Schenker said to the Senate Committee (Page 262):*

"Mr. Schenker: Subsection (e) of section 17 attempts to set forth a broad standard of conduct.

You made a suggestion originally, Senator Taft, to this effect: Why can you not set forth in this bill a fiduciary obligation and make it a crime to violate that fiduciary obligation?

When we came to draft a provision like that it presented a great many problems, **because if you try to impose a trustee obligation on these managers, maybe that obligation is much too strict. A trustee in some instances may be liable for negligence. We felt that that was possibly too onerous an obligation to impose upon people who are managing investment companies. So we took the broader approach and said that if he was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime.**

Of course that does not mean that the Securities and Exchange Commission has the jurisdiction to determine whether he has been guilty of gross abuse of trust. That is a criminal offense, and criminal action would have to be instituted against him.

Senator Taft: There is a criminal statute which covers that, is there?

* Page references are to Part 1, Hearings S. 3580, Subcommittee of the Committee on Banking and Congress, United States Senate, Seventy Sixth Congress, Third Session

Mr. Schenker: Yes, sir; and penalties are provided for it. The penalties are referred to in section 43 on page 84 of the bill.

Senator Taft: Section 43 provides that any person who willfully violates any provision of this title or of any rule, regulation, or order hereunder shall upon conviction be fined not more than $10,000 or imprisoned not more than 2 years, or both.

That seems rather a stiff criminal provision.

Mr. Schenker: I do not think it is any different from the criminal provisions in other acts, and I think it must be read in the light of the fact that there is a special provision here which relates to violation of rules or regulations which says that the mere inadvertent violation of a rule or regulation is not sufficient to impose liability. If you read the balance of it you will find it says that no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no knowledge of such rule, regulation, or order.

Senator Taft: What kind of knowledge?

Mr. Schenker: Under those circumstances, Senator, I think he would have to prove beyond a reasonable doubt——

Senator Hughes (interposing): Actual knowledge would have to be proved.

Mr. Healy: **This bill says willful violation. I do not believe constructive notice would be sufficient.**

Senator Taft: He is presumed to know the law, but the facts may be different.

Senator Wagner: It cannot be willful if he knew nothing of the law.

Senator Taft: He does not have to know the law for it to be willful. He may inadvertently do the act, but if he willfully does it and that act is a violation of the law, he has violated the law. You are pre-

sumed to know the law. You may not know the facts. If the act is willful, it is a violation of the law, a willful violation of the law.

Senator Hughes: I have never heard any such construction of 'willful' as that."

During the hearings on S. 3580, as reported in Part 2 of the Senate Reports, Arthur H. Bunker, Executive Vice-President of the Lehman Corporation, New York City, speaking of the industry's views said at page 380:

> "Now, Senator, this bill contains one provision which I probably ought to leave to the lawyers to discuss; but I would like to say just one word. Section 17 (e) says:
>
> > 'Any gross misconduct or gross abuse of trust in respect of a registered investment company . . . shall be unlawful.'
>
> Now, Senator, no one can quarrel with the general idea. Certainly, I have no word to say in favor of misconduct or abuse of trust, whether it is gross or petty; but I think you will sympathize with anyone's unwillingness to be subjected to a criminal penalty for violation of so indefinite and undefinable a prohibition."

Later on in the hearings Mr. Bunker, in summing up, stated page 1056, Part 2:

> "The obscure and indefinable provision in Section 17 regarding gross misconduct and gross abuse of trust should be eliminated."

The Senate Committee agreed with the industry objections, and Section 37 of the Act was substituted, whereby it was made a crime to steal from an investment company. The section as finally enacted provides (15 U. S. C. A.):

"80a-36. Larceny and embezzlement

Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a-48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts. Aug. 22, 1940, c. 686, Title I, § 37, 54 Stat. 841."

The discussion which preceded the changes was reported by Alfred Jaretzke, counsel for the closed-end companies, in the hearings which were held after the amendments were agreed to before the Subcommittee on Interstate and Foreign Commerce, House of Representatives, Seventy-Sixth Congress, Third Session, on H. 10,065, Jaretzke stating at page 124:

"The original bill contained a provision making unlawful gross misconduct and gross abuse of trust on the part of officers and directors of investment companies and consequently making such conduct subject to the penalties of the Act. The group I represent objected to this provision on the ground that it subjected persons to criminal penalty **for violation of an indefinite standard which was impossible of determination.** In arguing that this provision be eliminated from the Bill, the Securities and Exchange Commission suggested as a partial substitute therefor that larceny and embezzlement of investment companies should constitute a federal crime. It is my understanding that the record shows a number of instances of misconduct on the part of officers and directors of investment companies which would constitute larceny and embezzle-

ment and it seemed entirely appropriate to the industry that, as the Federal Government was to take jurisdiction over the industry, it should have jurisdiction to prosecute such officers. The investment companies as a body have taken the position that any provision of this kind that might tend to keep dishonest persons out of the business was salutary and in the best interests of the industry and they would certainly not wish to question a provision of this sort."

The gross abuse of trust section, originally 17 (e), became Section 36 (15 U. S. C. A. 80a-35), whereby the Commission was authorized to bring civil actions in the District Courts of the United States to enjoin an officer or director from serving or acting if such person has been "guilty" of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts. Senate Report 1775, Senate Miscellaneous Reports, Volume 3, at page 15 of the report, describes the end results of the changes in this language:

> "Officers and directors of investment companies and certain other persons are not allowed to exculpate themselves from liability for any willful misfeasance, bad faith, gross negligence, or reckless disregard of their duties (Sec. 17). . . . Gross misconduct or abuse of trust by directors, officers, investment advisers, principal underwriters, etc., is made a basis for injunctive proceedings in a federal court to be instituted by the Commission (Sec. 36). Larceny or embezzlement of property of investment companies is made a federal crime (Sec. 37)."

It is the contention of respondents that the foregoing legislative history shows that the Commission sought from Congress a statute which would regulate investment companies by requiring registration, and also directors by

likewise requiring registration. Mr. Schenker's statement as the hearings progressed shows that the imposition of so-called trustee obligations on directors with liability for ordinary negligence was not intended. The Commission sought to fix individual responsibility on directors by Section 17 (e) providing that registered directors would be guilty of a crime for gross misconduct and gross abuse of trust. The Senate Committee was unwilling to accept such far reaching consequences to directors on a standard so nebulous as to be no standard at all. The deletion of the registration provisions for directors and the substitution of removal of officers and directors for gross misconduct indicates that Congress did not enter the field of director responsibility.

A complaint which charges by name and description the defendants who committed unlawful acts and received the illegal fruits of the scheme, and which disavows concert of action on the part of the independent directors does not state a federal case notwithstanding it is charged such directors had actual or constructive knowledge or negligently failed to discover the wrongful acts of others. The Court of Appeals in this case rightly held that the "complaints here substantially seek to hold these former directors to strict liability as insurers" (R. 71). The court had reference to Fund's contention that violation equaled liability respecting which due care is no defense,** and the weight of authority to the effect that violation of a criminal statute is negligence per se,* or creates strict liability.*

** O'Donnell v. Elgin, Joliet & Eastern Railway Company, 338 U. S. 384-395, 94 L. Ed. 187 Holding the Safety Appliance Act is a strict liability statute.

* Prosser on Torts, Second Edition, page 152, Section 34; Ezra Ripley Thayer, "Public Wrong and Private Right"; 27 Harvard Law Review 1913-14, p. 314; Clarence Morris, "The Relation of Criminal Statutes to Tort Liability; 46 Harvard Law Review 1932-3, p. 453

3. The doctrine of implied liability is not applicable.

The Fund's brief and the amicus brief of the Securities and Exchange Commission have directed attention to the federal cases wherein the Federal Courts (but not this court) have implied civil remedies and federal jurisdiction in cases under other Security Acts. The authorities are also reviewed at length in Brouk et al. v. Managed Funds, Inc., et al., 286 F. 2d 901; Brown v. Bullock, 194 F. Supp. 207 (S. D. N. Y. 1961), affirmed by the Second Circuit, September 5, 1961, not yet officially reported, C. C. H., Fed. Sec. Law Rep., Current, Par. 91046, pages 93515-93523.

Respondents recognize that the courts have developed a line of cases under the Securities Act of 1933 (15 U. S. C. A. 77a-77aa) and the Securities Exchange Act of 1934 (15 U. S. C. A. 78a-78jj), and have applied the doctrine of implied liability based on the violation of a federal statute as implying a civil action in tort, or on the ground that the statute declared certain proscribed contracts to be void. These remedies are available in purchase and sale situations, and are grounded in fraud, but not limited to common law fraud. These acts provide for civil remedies, but the courts have implied liabilities in areas not specifically within the statute. Louis Loss calls this a "surprising development," but approves the trend and believes that "the courts would be shrinking from their traditional function of supplying the lubricant for the legislative machinery if they were to hold back."* Respondents disagree, and shall undertake to show that on both reason and authority the expansion of federal jurisdiction to director cases is not indicated.

In the securities field the Brouk case and the Brown case involve the question of implied liability as related

* Vol. III, Louis Loss Securities Regulations (2d Edition, 1961), pp. 934-937, 1757-1763, 1435; Vol. II, 945.

to directors and the Investment Company Act of 1940. The court in the Brown case noted it granted a special appeal because the issue was novel and of public, as well as private importance, particularly in view of a large number of cases against directors pending in the Southern District. (Brown v. Bullock, 194 F. 2d 207, affirmed, C. C. H., Sec. Rep., Current, Par. 91046, p. 93515.)

As the authorities cited in Brouk show (R. 58) jurisdiction has been declined under many federal statutes. The reasoning against implied jurisdiction is stated by the court in a Safety Appliance Act case, Jacobson v. New York, N. H. & H. R. Co., 206 F. 2d 153, affirmed per curiam 347 U. S. 909, 98 L. Ed. 1067, as follows, l. c. 156:

> "Where there is only a criminal penalty, and no mention of any civil remedy, many courts have read into the statute a supposed or 'presumed' intent to provide one. 'In the ordinary case this is pure fiction, since the obvious conclusion is that the legislature either did not have the civil action in mind at all, or deliberately omitted to provide for it.' Prosser on Torts (1941) 265. This was squarely recognized in Gilvary v. Cuyahoga Valley Ry Co., 1934, 292 U. S. 57, 54 S. Ct. 573, 78 L. Ed. 1123. Furthermore, the Court there commented, 292 U. S. at page 61, 54 S. Ct. at page 575, that if Congress had had the purpose of creating a right of action in favor of persons not covered by the Employers' Liability Acts, 'Congress probably would have included provisions in respect of venue, jurisdiction of courts, limitations, measure of damages, and beneficiaries in case of death.'
>
> (4) But though Congress has not created a statutory right of action in favor of passengers injured as a result of violation of the Safety Appliance Acts, it is still possible for the courts to do so on principles of the common law. The breach of a penal statute

may be regarded by the courts as an operative fact upon the basis of which may be predicated a common law tort liability to a person injured as a result of the breach, provided he is within the class for whose protection the penal statute presumably was passed. The courts of the various states differ extensively in their formulation and application of the common law principle upon which a liability is created in favor of a person injured by breach of a criminal statute. Some courts speak of the breach as 'negligence per se', others as 'evidence of negligence' or as 'prima facie evidence of negligence.' Nor are they completely in agreement as to what is meant by these phrases. Furthermore, liability in such cases is fitted into whatever local variations there may be in common law doctrines as to contributory negligence, last clear chance, assumption of risk, proximate cause, etc.

The common law principle referred to in the previous paragraph was broadly stated in the leading case of Texas & Pac. Ry. Co. v. Rigsby, 1916, 241 U. S. 33, 39, 36 S. Ct. 482, 484, 60 L. Ed. 874, as follows: 'A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied, according to a doctrine of the common law * * *.' If the federal courts had undertaken to apply this principle as a matter of federal decisional law, in the case of a breach of the Safety Appliance Acts resulting in personal injury to a person not entitled to sue under the Employers' Liability Acts, and if such liability had been imposed as a matter of federal common law without reference to local variation of statutory law or of common law doctrine applicable in the state where the injury occurred, it would perhaps follow that a complaint

setting up such a liability would be a civil action arising 'under the Constitution, laws or treaties of the United States' within the meaning of 28 U. S. C. § 1331. See Reitmeister v. Reitmeister, 2 Cir., 1947, 162 F. 2d 691; Mater v. Holley, 5 Cir., 1952, 200 F. 2d 123. Cf. Odell v. Humble Oil & Ref. Co., 10 Cir., 1953, 201 F. 2d 123; Doucette v. Vincent, 1 Cir., 1952, 194 F. 2d 834, 839 et seq. See also Erie Railroad Co. v. Tompkins, 1938, 304 U. S. 64, 71-73, 58 S. Ct. 817, 82 L. Ed. 1188.

(5) But it is abundantly clear that the federal courts have not, as a matter of federal common law, developed a private right of action for damages for personal injuries resulting from a breach of the Safety Appliance Acts, in favor of persons not entitled to sue under the provisions of the Employers' Liability Acts."

Until this case this court has not been called upon to determine whether Investment Act cases are to fall within the domain of those deemed to be within or without the jurisdiction of federal courts. Charles L. B. Lowndes considers that the process of arriving at a conclusion when determining a question of implied liability involves the judicial process of interpreting the meaning of the statute rather than finding legislative intent.* As the court noted above, the courts have differed extensively in treatment of the problem of implied civil liability. Thayer suggests that confusion of thought is hidden behind "ambiguous and question begging phrases." He says, 27 Harvard Law Review 317:

"'A lucid vocabulary' as Professor Graywood has said 'is the fruitful mother of evils,' and in the present

* Civil Liability Created by Criminal Legislation, 16 Minnesota Law Review, 1931-32, p. 361

> instance the slippery word 'duty' and 'negligence' are responsible for much of the progeny. Too often the mere statement of a conclusion that 'the statute creates a duty to the plaintiff' is used as if it furnished some reasons in its own support. At times it is coupled with the further assertion that 'the plaintiff therefore has a remedy' as if this were something more than an identical proposition. In either form the question how the duty arose, and what it was that gave rise to it is left in the same darkness as before. But this is manifestly the very question at issue. In seeking the principles which determine the answer, the infinite variety of criminal statutes must be faced at the outset. The field includes the whole range of human activity, and legislative treatment must vary correspondingly."

Prosser says that "much ingenuity has been expended in the effort to explain why criminal legislation should result in civil liability" (Second Edition, p. 152). We allude to these statements of these scholars to highlight the problem and to suggest that the considerations urged by Fund are by no means decisive. Each statute must be viewed separately. Security cases under other acts do not control this case.

The Dotterweich case relied on by Fund merits discussion at this point.

United States v. Dotterweich, 320 U. S. 277, 88 L. Ed. 48, is cited by Fund to support the contention that in a misdemeanor case where only corporate conduct is proscribed **officers** are liable, and that by analogy the **directors** here should be likewise liable civilly.

The majority reviewed the history of the Act and noted that the 1906 Food and Drug Act provided that the acts of officers and agents were deemed to be the acts of the

corporation and that the 1938 amendment omitted these words. It was held that under "legal understanding" the words were superfluous and unnecessary to hold a corporation for violation. The court found no legislative intent by the deletion to hold only corporations and concluded Dotterweich, who was president and general manager, was subject to conviction for the corporation's shipment of misbranded goods in interstate commerce.

Mr. Justice Murphy wrote the dissent in which he was joined by Mr. Justice Roberts, Mr. Justice Reed and Mr. Justice Rutledge. Mr. Justice Murphy pointed out that a corporation "is not the necessary and inevitable equivalent of its officers for all purposes," and notes "a complete absence of any reference to corporate officers" (320 U. S., l. c. 287, 288). Speaking of the deletion from the Federal Food & Drug Act of the provision that "any violation of the Act by a corporation should be deemed to be the act of the officer responsible therefor, and that such officer might be punished as though it were his personal act" (l. c. 290), the minority concluded (l. c. 292):

> "We cannot presume that this omission was inadvertent on the part of Congress. United States v. Harris, supra (177 U. S. at 309, 44 L. Ed. 781, 20 S. Ct. 609). Even if it were, courts have no power to remedy so serious a defect, no matter how probable it otherwise may appear that Congress intended to include officers; 'probability is not a guide which a court, in construing a penal statute, can safely take.' United States v. Wiltberger, supra (5 Wheat. (U. S.) at 105, 5 L. Ed. 45). But the framers of the 1938 Act had an intelligent comprehension of the inadequacies of the 1906 Act and of the unsettled state of the law. They recognized the necessity of inserting clear and unmistakable language in order to impose liability on corporate officers. It is thus unreasonable to assume that the omission of such language was

due to a belief that the Act as it now stands was sufficient to impose liability on corporate officers. Such deliberate deletion is consistent only with an intent to allow such officers to remain free from criminal liability. Thus to apply the sanctions of this Act to the respondent would be contrary to the intent of Congress as expressed in the statutory language and in the legislative history.

The dangers inherent in any attempt to create liability without express Congressional intention or authorization are illustrated by this case. Without any legislative guides, we are confronted with the problem of determining precisely which officers, employees and agents of a corporation are to be subject to this Act by our fiat. To erect standards of responsibility is a difficult legislative task and the opinion of this Court admits that it is 'too treacherous' and a 'mischievous futility' for us to engage in such pursuits. But the only alternative is a blind resort to 'the good sense of prosecutors, the wise guidance of trial judges, and the ultimate judgment of juries.' Yet that situation is precisely what our constitutional system sought to avoid. Reliance on the legislature to define crimes and criminals distinguishes our form of jurisprudence from certain less desirable ones."

Like the Dotterweich case so in this case the provisions of the original bill for registration and regulation of directors were deleted prior to passage. Unlike the Dotterweich case this case involves not a president or general manager, but directors, and it cannot be said that any "legal understanding" exists which imposes on directors liability for corporate acts. The deletion left the Act with no federal duties or standards, and the duties of directors remained those at common law and as provided by the laws of the several states.

The wisdom of Congressional handling of federally created civil rights is attested by the difficulties encountered when the courts judicially imply liabilities. In the case at bar the briefs point to the sections of the Investment Company Act making unlawful advisory contracts unless approved by shareholders or annually by directors, the assignment of advisory contracts, and changing the stated policy.

In Brown v. Bullock, 194 F. Supp. 207, the District Court found implied liability under eight sections of the act, i. e., 15 (a) (3), 17 (h) and (i), 20 (a), 34 (b), 36, 37, 44 and 47 (b) relating to, respectively, stockholders' right to terminate advisory contracts, invalidity of exculpatory clauses, proxy solicitation, untrue statements, gross misconduct and gross abuse of trust, willful conversion and invalidity of contracts violating the Act. A forty-three page opinion was required to find what Congress did in a few lines in the Investment Company Act by Section 30 (f) [15 U. S. C. A. 80a 29 (f)] when it provided for the only director liability in the Act, insider trading, by saying a director was subject to the liabilities of Section 78p of the Exchange Act [15 U. S. C. A. 78 (p)]. This section says any profit realized by a director "shall inure to and be recoverable by the issuer" and "suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction." A two year limitation is provided. If the issuer fails to sue the owner of "any security of the issuer" may sue.

The Congressional approach in situations respecting federally created liabilities of directors under Securities Acts is well illustrated by the discussion of the Court of Appeals in Martin v. Hull, 92 F. 2d 208. The Court was considering director liability under the Securities Act of 1933, which expressly by its terms makes a director liable

to purchasers when a registration statement contains untrue statements. [Securities Act of 1933, § 11 (a, c). § 11 (b) (3) (c), as amended, 15 U. S. C. A., § 77k (a, c), § 77k (b) (3) (c).] Referring to the House Committee Reports the court stated, l. c. 210:

> "According to the statement of the House conferees accompanying the Conference Report on the bill, 'a point of difference between the House bill and the Senate amendment concerned the civil liability of persons responsible for the flotation of an issue. The Senate amendment imposed upon the issuer, its directors, its chief executive and financial officers, a liability which might appropriately be denominated as an insurer's liability. They were to be held liable without regard to whatever care they might have used for the accuracy of the statements made in the registration statement. The House bill, on the other hand, measured liability for these statements in terms of reasonable care, placing upon the defendants the duty, in case they were sued, of proving that they had used reasonable care to assure the accuracy of these statements. The standards by which reasonable care was exemplified was expressed in terms of a fiduciary relationship. * * * In choosing between these two standards of liability, the Senate accepted the standards imposed by the House bill.' This standard in the 1933 act is set forth in section 11 (c) (48 Stat. 82) as follows: 'In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship.'
>
> "The standard of reasonable care was restated in the Securities Exchange Act of 1934, which amended section 11 (c) to read as follows: '(c) In determining,

for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.' [15 U. S. C. A. § 77k (c).]"

The foregoing emphasizes that when Congress enters the field of director responsibility it does so by specific language. It is mindful of the kind of liability it imposes, who may sue and the defenses to be available to directors.

The reports to which we have referred relating to the hearings respecting the Investment Company Act fail to show that at any time these questions were discussed at all.

When the Second Circuit reviewed Brown it found it "unnecessary to pass on much that was said by the District Judge or to explore other grounds of federal jurisdiction asserted by appellees and found in their favor by him—at least one of which, that based on the allegedly false or misleading proxy statements, bristles with difficulties."*

The court in its banc opinion sustained the District Court only on two grounds, the first that Section 37 of the Act (15 U. S. C. A. 80a-36) gave rise to a civil action, the court holding that the language "whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any monies . . . of any registered investment company shall be deemed guilty of a crime" embraced a situation where it was charged that there was an unlawful and willful conversion. The court says, page 94518, that:

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* C. C. H. Fed. Sec. Ser. Current, Par. 91046, page 93516 (subsequent references to pages will be to the CCH Current Service).

> "We should think it clear that a director who had authorized corporate funds to be paid as compensation for services to a person known to him to have rendered none was guilty of knowing or willful conversion in the criminal sense."

The court concedes that to charge such a case as a basis for a civil action, it would have to be averred that the conduct of the director was willful. The amended petition of Fund in this case contains no such averment. The court also bases its holding of federal jurisdiction upon Section 15 (a) and (b) [15 U. S. C. A. 80a-15 (a) and (b)], which makes it unlawful to act as an investment adviser for more than two years unless the contract is specifically approved annually by the Board of Directors, or by a vote of the majority of the outstanding securities of the company. It holds, page 93518, that this section requires

> "not merely ceremonial performance of the act of approval, but its performance in a meaningful fashion, and that the breach of the latter requirement creates a federal claim as breach of the former unquestionably does."

The court further said:

> "We think 15 (a) and (b) laid down a requirement of annual approval not merely formal but substantial, the minimum content of which is a matter of federal law; hence a complaint alleging a failure to conform to that requirement sets forth a federal claim" (page 93519).

The court specifically announces its disagreement with Brouk.

Judge Moore dissented. The basis for his dissent is that the word "willfully," as used in the criminal section, is not to be transplanted to embrace an alleged conversion in a civil case. He disagrees with the majority that the

acts charged in the Brown complaint would support a criminal indictment. Of particular force is Judge Moore's analysis when he states (page 93522):

> "The majority say that Congress 'must have been concerned with the substance and not simply with the form.' But these words are merely abstractions **'without some standard by which to test for substance or form.'** Is a corporate resolution reading in substance that 'the services having been found to have been satisfactory, be it resolved that the contract be renewed for another year', legal or illegal? Must the state of mind of each director be explored by examination and cross-examination to ascertain as to each decision made whether 'approval was given without any real consideration of the merits.' . . .
>
> "By the decision of the majority, this case will have to go to trial. If the life spans of the case and the court happily coincide we may be able to see the beneficial effects upon society of striking 'fear of personal liability' into the minds of potential wrongdoers, thus compelling them 'to walk in the paths of rectitude'—paths to be sure which **neither Congress nor the courts have laid out with such markers as may be easily discernible by the pedestrian director.** There should be more constitutional methods of permitting every stockholder to be a Sir Galahad than this in terrorem approach."

The striking from the original bill Section 17 (c) with its lack of a standard respecting gross abuse of trust as a crime supports Judge Moore's conclusion and the contention of respondents that the amended complaint does not state a federal case.

The District Court in Brown had determined that a civil action would lie by implication for conduct by a director constituting "gross misconduct or gross abuse of trust"

relying on Section 36 providing for injunction in such cases. Here again Fund's amended complaint does not attempt to plead a case based on gross misconduct and gross abuse of trust. The acts described insofar as they relate to the respondents here, the independent directors, when viewed in light of the specific averments of negligence, constructive knowledge, etc., do not constitute averments of the violation of Section 36 as a basis for liability on the part of respondents. Respondents, however, contend that the District Court in Brown was in error in the holding that Section 36 gives rise to an implied civil action. It is limited to injunctive proceedings at the behest of the Commission.

C. **Federal jurisdiction must be pleaded affirmatively and distinctly.**

Respondents agree with petitioners and the accepted rule announced by this court that the Federal Rules permit notice of pleading and complaints are not to be dismissed unless it appears beyond doubt that the plaintiff can prove no set of facts which would entitle plaintiff to relief. Equally well settled by this court is the requirement that jurisdiction must affirmatively appear. The principle is stated in Thomas v. Ohio State University Trustees, 195 U. S. 207, 25 S. Ct. 24, 49 L. Ed. 160, l. c. 163, as follows:

> "That the jurisdiction of a circuit court of the United States is limited in the sense that it has no jurisdiction except that conferred by the Constitution and laws of the United States; that a cause is presumed to be without its jurisdiction unless the contrary affirmatively appears; that such jurisdiction, or the facts upon which, in legal intendment, it rests, must be distinctly and positively averred in the pleadings, or should appear affirmatively and with equal distinctness in other parts of the record, it not being sufficient that

> jurisdiction may be inferred argumentatively; and that, for the purposes of suing and being sued in a circuit court of the United States, the members of a local 'corporation' are conclusively presumed to be citizens of the state by whose laws it was created, and in which alone the corporate body has a legal existence—are propositions so firmly established that further discussion of them would be both useless and inappropriate."

The pleader must point not just to a federal statute, but to a federal statute creating federal duties and rights of action in Federal Courts. This, respondents assert, petitioner has failed to do.

CONCLUSION.

This record does not present a case where a decision by this court declining federal jurisdiction will defeat the purposes of the Act and leave shareholders or Fund without a remedy. The state courts are open and by the Act have jurisdiction. State law will govern the duty of directors, statutes of limitation, negligence, degrees of care, breach of fiduciary obligations, good faith, contribution, indemnity and all the aspects of this type of litigation, none of which have received Congressional attention in the Investment Company Act. The amended complaint pleads only a state court mismanagement case and attempts to charge violations of the Federal Act to create a spurious case of federal jurisdiction so as to invoke the "long arm" service statute and bring respondent Rice from Florida and respondent Rebstock from Louisiana into the District Court of Missouri. Federal jurisdiction, choice of forum and long arm service must stem from a federal case.

The decision of the Court of Appeals ordering dismissal of Fund's amended complaint as to the respondent direc-

tors should be affirmed. There is no occasion for this court to start the evolution of a body of federal law.

Respectfully submitted,

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